CHASE

International Finance

Vol. XV, No. 2
January 21, 1980

Issued bi-weekly by the Economics Group of The Chase Manhattan Bank
for corporate customers and correspondent banks

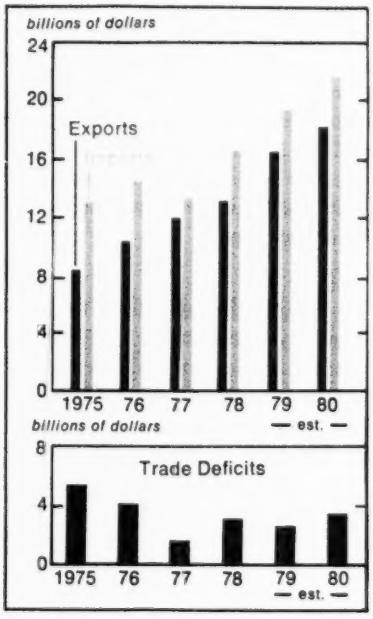
B 1700-1

U.S. Grain Embargo: A Squeeze on Soviet Consumers

President Carter's surprising decision to restrict U.S. grain sales to the Soviet Union has unleashed much speculation as to the impact on the Soviet economy. The limit on U.S. grain sales to the USSR is now 8 million metric tons for 1980, the maximum specified under the five-year U.S.-USSR grain agreement that expires next year. The USSR already held contracts for an additional 13 million tons and probably would have purchased a total of 25 million tons—the amount the United States made available last fall.

The embargo will have a positive impact on the Soviet foreign trade balance in 1980. Higher prices for crude oil and metals in the second half of 1979 narrowed the Soviet trade deficit with the West to an estimated $2.8 billion last year, down from $3.3 billion in 1978 and below the $3.1-$3.4 billion forecast in July. In 1980, the U.S. grain embargo is projected to reduce Soviet imports from the West by about $2 billion. Soviet demand for Western machinery and other goods is expected to remain strong, however, given the pace of Soviet investment activity coinciding with the end of a five-year plan. Overall, the 1980 Soviet trade deficit with the West is projected to reach only $3.5 billion, a level that would mean virtual balance on current account.

Soviet trade with the West



As for the impact of the embargo on Soviet meat production in 1980, livestock herds will probably decline by approximately 2% by midyear, with reductions concentrated in swine rather than cattle. Supplies of feed will fall by 5%-7% this year as existing stocks are depleted more rapidly and as Soviet farms shift toward more intensive use of pasturage. The U.S. Department of Agriculture's initial analysis that the embargo would result in a huge 13% drop in Soviet meat output appears to be an exaggeration. More likely, meat production will be 3%-4% less than otherwise in 1980-81, with higher meat imports partly offsetting the shortfall in domestic supplies.

The long-term implications of the embargo are more serious. For the United States, it will mean the narrowing of a major export market in the 1980s and the need for grain set-aside programs to maintain farm incomes. For the Soviets, it will mean less supplies of badly needed U.S. grain over an extended period. To accommodate a reduced reliance on U.S. feed grain, the Soviet leadership will have to maintain the current high share of investment devoted to agriculture. And since grain production is costly under Soviet conditions, consumers will have to accept lower meat supplies—at perhaps higher prices—as well as slower growth in the output of other consumer goods during the 1980s.

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French Government moves to ease impact of higher oil costs.

The French Government has announced proposals to help the economy adapt to oil price increases. The country's oil import bill for 1980 is estimated at FF100 billion, double that of 1978. The higher cost of crude oil has been quickly reflected in the price of refined products, including gasoline. Gas and electricity rates to domestic consumers have been boosted 11.8% and 10.8%, respectively. To ensure that industry's plans are not cut back by the higher oil prices, FF7.5 billion has been earmarked for investment aid, with FF1.5 billion of this sum to be allocated for research into energy conservation. At the same time, additional funds will be made available for the nuclear program. The measures are expected to add 0.9% to the rate of increase in consumer prices, which was running at 11.5% in November. To offset the impact of such price rises, however, the Government plans to increase social aid allocations, bringing to FF3.5 billion the total amount of such assistance provided since last August.

Economic activity in Finland likely to decline as 1980 progresses.

Latest estimates for Finland's GDP growth in 1979 are approaching 8%, and the prospect that such rapid expansion will spill over into 1980 is giving rise to concerns about possible overheating. Much of the recovery is due to a strong export performance; export volume is up 14% from last year. Average export growth for 1980 is also likely to be strong, but the economic climate is expected to deteriorate as the year progresses. Higher oil prices have more than offset the effect of buoyant exports, and the balance of payments—in surplus for the last two years—is now showing a deficit that looks set to widen over the next few months. The inflation rate has also begun to accelerate; it may reach 10% in 1980, compared with 7.4% last year. With Finland heavily dependent on international trade, its 1980 growth prospects will undoubtedly be adversely influenced by slowdowns in the remaining Western European economies.

Israeli policy of austerity may ease inflation and payments imbalances.

In late 1979, Israeli authorities were faced with two major problems. The rate of inflation had reached well over 100%, and the trade deficit of $4 billion for the year looked set to widen even further. The Government's response was to introduce corrective policy measures in November, which included a credit freeze, an increase in import duties, and reductions in price subsidies and public-sector manpower. These steps were expected to boost the consumer price index by some 20% in the short run, but there are now signs that the overheated economy is cooling off. The level of housing starts has fallen, along with spending on consumer durables. Real GDP growth in 1980 is likely to be less than half the 5% rate of 1979. If the negative consequences for employment are accepted, the measures should improve the price outlook in the medium term and help offset the impact of higher oil prices on the balance of payments.

Nicaraguan economy in the aftermath.

The recent political crisis in Nicaragua has taken a heavy toll on the country's economy. Physical damage to productive capacity is estimated at $480 million—in the context of a pre-war GDP of $2.3 billion—and led to a 25% decline in economic activity in 1979. Industry and commerce were hit especially hard; indeed, some 10% of industrial productive capacity has been lost. Agricultural capacity, the principal determinant of Nicaragua's balance-of-payments position, experienced minor physical destruction, but the losses associated with foregone production are significant. The war curtailed crop plantings sharply and prevented optimum care of existing crops; as a result, the 1979/80 crop may be 40% below the previous season's level. On the external front, the country is faced with a major liquidity crisis. Capital flight has been heavy, exceeding $300 million, and the country is saddled with $1.6 billion in external—mostly short-term—debt. Since Nicaragua is in no position to meet its external obligations, the revolutionary government is taking steps to renegotiate its debt to the international banking community.

Brazil retrenching to check inflation and external debt growth.

The Brazilian Government is faced with the formidable challenges of reducing inflation and limiting the growth of external debt. Last year Brazil's inflation rate rose to 77%—the third highest rate in Brazil's history—and its external debt topped $50 billion. In response, the Government devalued the cruzeiro by 30% in late 1979 and launched an effort to eliminate price and trade distortions in order to promote a more competitive economic system. Fiscal and monetary policies are currently more restrained and the authorities are seeking to moderate wage increases. The objective is to reduce inflation and improve the balance-of-payments position, while minimizing the cost in terms of economic growth. In 1979, real GDP grew 7%, but if the more cautious policies are adhered to throughout 1980, GDP growth could decline to some 5%. This would reduce import requirements and, consequently, external finance requirements. If Brazil succeeds in these areas, and also manages to reverse the upward trend in inflation, it will be laying a solid foundation for fast growth in the years ahead.

Philippines unveils new industrial development strategy.

The Philippines has introduced a three-pronged industrial development strategy to accelerate economic growth over the next few years. Prompted by lackluster growth of about 5% in 1979, the impact of ever-increasing energy costs, and the prospect of current-account deficits exceeding $2 billion, the Government has put forward an ambitious program aimed at relieving the structural imbalances in external payments and boosting economic growth. The program will necessitate heavy external borrowing. It consists of a $6-billion investment in large industrial projects, including copper and aluminum smelting, cement, steel, and petrochemicals; restructuring existing industry by encouraging exports rather than import substitution; and enhancing the importance and efficiency of the export sector by reducing bureaucratic red tape and providing added incentives. The three elements of the strategy, however, appear to be somewhat incompatible, and some observers feel that the large industrial projects should be scaled back. Nevertheless, the greater emphasis on exports is widely supported and could reverse the steady deterioration in the Philippine balance of payments.

Bahrainian economy poised for an upturn.

Despite declining crude production, the 1980s hold the prospect of renewed economic buoyancy for Bahrain, after the recent slowdown in economic activity. Final approval has been given for the construction of the $1-billion, Saudi-financed, causeway to the mainland. Invitations to bid have been sent out, and actual construction is expected to begin in 1981. In addition, a $70-million borrowing has been arranged for the expansion of the Alba aluminum smelter plant, while a $95-million gas-gathering and liquifaction plant opened in December. These projects, combined with the positive impact of oil price hikes on the Gulf nations, can be expected to bolster the Bahrainian economy and provide a much-needed stimulus to the construction and other service sectors—despite the current political turmoil in the region.

Nickel price outlook is bullish.

Nickel prices began 1980 nearly 50% above year-ago levels. And the outlook is for further price rises during the year, despite growing indications of a U.S. recession and economic slowdowns in other countries. Nickel consumption in the West was up by as much as 10% in 1979, the result of record demand for stainless steel and other nickel alloys. In addition, supply was restricted by a nine-month strike at International Nickel Co. facilities in Canada (from September 1978 to June 1979) and deliberate restraints on production by other major producers. As a result, previously excessive inventories have now been drawn down to below-normal levels. Moreover, while demand for nickel will weaken with a cyclical decline in capital goods and construction, the contraction in real capital spending is expected to be relatively mild, and aerospace demands should continue strong. Major producers are thus in an excellent position to weather the storm by cutting back production and adding to inventories. Indeed, producer pricing has reasserted itself in the nickel market.

A Time for Policy Reappraisal

Ever since the Great Depression of the 1930s, concern for unemployment in the United States has overshadowed concern for inflation. The enactment of the Employment Act of 1946 established the Council of Economic Advisors with the objective of achieving "full employment", and the Full-Employment and Balanced-Growth Act of 1976 (the Humphrey-Hawkins bill) reaffirmed the commitment. Nevertheless, the goal has proven elusive, as the lowest rate of unemployment consistent with a stable rate of inflation—the "full-employment unemployment rate"—has ratcheted upward.

Policymakers have felt free to focus on the unemployment problem because, until the late 1940s, inflation was a phenomenon associated primarily with war. And although the link between Federal budget deficits and inflation is not always direct, deficits also tended to occur only during time of war. Prices would generally rise rapidly during wartime, but would then fall back to their pre-war level when the fighting ended. With the cessation of war, the budget would typically return to surplus and the accumulated war debt would be gradually paid off.

After World War II, however, prices failed to fall back to their pre-war level and the accumulated Federal debt was never repaid. Although inflation continued to be a problem up until 1953, prices advanced very slowly between 1953 and 1965, and inflationary expectations receded. The apparent success of the 1964 tax cut in moving the economy toward full employment while maintaining a low inflation rate encouraged policymakers to reach into the fiscal policy grab-bag at the next sign of trouble.

In 1969, however, after several years of budget deficits associated with the Vietnam War and with unemployment below the level at which inflation tended to accelerate, higher inflationary expectations emerged. Unemployment began rising around midyear, but was still below the prevailing full-employment level of 4% by year-end; inflation was a then-high 6%. Nevertheless, fiscal policy shifted from restraint to stimulus with the Tax Reform Act of 1969. As a result, the operating budget shifted from an annual rate of $5 billion surplus in second-quarter 1969 to a deficit of $15 billion a year later. The cost of being unemployed was also reduced by the Government's extension of coverage and duration of unemployment compensation and its easing of eligibility requirements for food stamps. These actions helped ratchet up both inflationary expectations and the rate of unemployment

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANCE				
			3 months ending	Change from year earlier	In billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	us cr lions
Africa	Algeria	Consideration given to exporting more gas in future by pipeline and less in LNG form.	Sept.	+ 54%	19.3*	$ 1,075	Nov.	2,210	+ 76%	3.4	
Africa	Botswana	Oil conservation measures hurt agriculture, transport, and tourism.	Sept.	+ 90%	0.4	557	Nov.	272	+ 95%	5.8	
Africa	Cameroon	Domestic private investment accelerating rapidly.	Mar.	+ 6%	4.0	500	Aug.	94	— 19%	1.0	
Africa	Egypt	Negotiations with IMF resume in February for new credit; West pledges $2.5 billion for 1980.	June	+ 69%	18.8*	484	Sept.	322	— 22%	1.2	
Africa	Ivory Coast	Official estimates place 1979/80 cocoa crop at 260,000 metric tons, versus 312,000 in 1978/79.	June	+ 11%	7.6	1,440	Sept.	213	— 27%	1.3	
Africa	Kenya	Shortages of imported supplies held real growth to an estimated 3%-4% in 1979.	Feb.	— 14%	5.5	370	Nov.	635	+ 83%	4.6	
Africa	Libya	Higher oil revenues and budget outlays will accelerate economic growth in 1980.	Sept.	+ 66%	17.5*	6,635	Oct.	5,349	+ 24%	9.2	
Africa	Malawi	Gross fixed capital formation rises sharply to 30% of GDP.	Aug.	+ 35%	1.1	187	Nov.	35	+ 25%	1.0	
Africa	Morocco	EEC will reduce trade barriers to imports of Moroccan wine, tomatoes, and textiles.	June	+ 19%	12.8	678	Oct.	362	— 30%	1.4	
Africa	Nigeria	President launches $30-million agricultural crash program.	Sept.	+ 75%	41.4	520	Nov.	4,981	+208%	6.7	
Africa	Senegal	Groundnut crop in 1979 showed significant improvement over 1978.	n.a.	n.a.	2.2	400	Sept.	24	+123%	n.a.	
Africa	South Africa	Real GDP growth in 1979 estimated at 3.5%; further improvement foreseen for 1980.	Sept.	+ 45%	45.7	1,650	Nov.	997	— 10%	1.4	
Africa	Sudan	Outlook for 1979/80 cotton crop continues to be disappointing.	Mar.	+ 72%	7.1	400	Nov.	30	+ 7%	0.3	
Africa	Tunisia	Budget for 1980 will emphasize industrial development, social welfare, and education.	June	+ 39%	5.8	936	Nov.	625	+ 50%	3.3	
Middle East	Iran	Oil Minister projects output of 3-3.5 million barrels oil per day this year.	Sept.	+ 3%	76.4*	2,227	Sept.	12,452	+ 8%	n.a.	
Middle East	Kuwait	Crude oil output likely to be reduced during 1980.	Sept.	+ 56%	13.9**	12,278	Nov.	2,715†	+ 4%	7.4	
Middle East	Saudi Arabia	Spending on infrastructure continues at a high level.	Sept.	+ 80%	54.5**	8,400	Nov.	18,502†	— 5%	9.8	
Middle East	United Arab Emirates	Federal budget for 1980 set at $3 billion, up 16% from 1979.	Sept.	+ 55%	13.2*	17,820	Nov.	1,098†	+ 62%	2.5	

*1977 **FY 1977/78 †Excluding State reserves

consistent with non-accelerating inflation.

In political terms, commitment to fighting recession rather than inflation is often appealing. The effect of a tax cut on real disposable income is immediate, allowing current levels of consumption, production, and employment to be higher than otherwise. The inflationary effect of a tax cut, on the other hand—assuming at least a partially accommodating monetary policy by the Federal Reserve—shows up much later.

New troubles came at the end of 1973 with the oil embargo and the subsequent quadrupling of energy prices. The increase in the relative price of energy reduced the level of potential output. But policymakers attempted to offset much of this loss in potential output by pursuing stimulative fiscal policies in the wake of the 1973-75 recession. At about the same time the economy was turning the corner on its own in early 1975, a huge tax cut package was implemented. Further extensions of the coverage and duration of unemployment compensation were legislated as well. So the full-employment unemployment rate and expectations of future inflation were increased once again.

Addtional output has accompanied the forces leading to inflation in the past. Hence, most economists agree that reducing inflation will not be costless. A sufficiently stringent monetary policy could offset the stimulative effects of fiscal policy to a great degree; the process might well involve lower levels of economic activity than would otherwise have occurred in the short run.

To reduce actual and expected inflation permanently, society's faith in the future must be restored. Legislative actions to ameliorate the effects of past business downturns have made accumulating debt less risky for households, encouraging a "buy now" attitude that recently has worsened inflationary pressures. It may well be that these attitudes can only be changed if government announces and adheres to new fiscal and monetary policies consistent with lower inflation. In this context, the recently adopted operating strategy of the Federal Reserve seems to be on the right track.

Policy measures to encourage saving, such as the removal of interest rate ceilings on individuals' deposits in banks and thrift institutions, would also be beneficial. These policies would be aided substantially by an easing of the Federal deficit. Indeed, after this year's recession-induced deficit, economic recovery and continued monetary and fiscal responsibility could swing the budget firmly toward surplus. This would reduce actual and expected inflation and eventually lower the full-employment unemployment rate.

Clearly, the policies of the last fifteen years will not be easily undone, and progress is likely to be painfully slow. But the costs of delaying—in terms of accelerating inflationary expectations and rising unemployment—will only increase. *Douglas L. Bendt*

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
f IMF t, mil- dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate (January 16, 1980)	exchange rate in U.S. dollars (January 16, 1980)	current monetary conditions	
0	Oil price at $33/barrel as of Jan. 1, up 10% from mid-December.	Dec. '78	+ 17%	July	+ 30%	—	.2750	A $28.5-million Euroloan obtained for dam construction.	Algeria
0	Strong diamond and meat prices boost export receipts.	Oct.	+ 15%	Oct.	—100%	5.75%	1.3150	Interest rates cut to stimulate agricultural investment.	Botswana
3	Oil refinery completion within year should swing oil account to surplus.	May	+ 5%	Aug.	+ 24%	—	.0050	Credit restraint continues.	Cameroon
1	Oil prices raised 23%; oil now provides 50% of merchandise export earnings.	Sept.	+ 14%	Sept.	+ 63%	9.00%	1.45	Money supply growing rapidly.	Egypt
0	Terms of trade expected to continue deteriorating through 1980.	Aug.	+ 22%	Aug.	+ 27%	8.00%	.0050	Money supply falls.	Ivory Coast
1	Current-account gap estimated to have shrunk to $400 million in 1979.	Aug.	+ 7%	June	+ 18%	—	.1415	IMF pressure to devalue shilling being resisted.	Kenya
0	Oil prices raised $4.72 since mid-December to $34.02-$34.72 per barrel.	n.a.	n.a.	Sept.'78	+ 9%	5.00%	3.41	A $1-billion investment company to be set up with Kuwait.	Libya
9	Higher capital-equipment imports and lower tea prices widen trade deficit.	Sept.	+ 14%	Oct.	+ 50%	8.00%	1.27	Credit continues restrictive.	Malawi
6	Imported oil bill rising rapidly.	Mar.	+ 10%	Sept.	+ 20%	4.50%	.2750	Loan of $15 mn. obtained from Islamic Development Bank.	Morocco
0	Oil price of $30/barrel will raise 1980 gross oil receipts to $25 billion.	May	+ 8%	July	+ 14%	5.00%	1.88	Large foreign-exchange inflow boosts money supply.	Nigeria
9	Trade gap in 1979 unlikely to have narrowed from $280 million in 1978.	Aug.	+ 13%	July	+ 31%	8.00%	.0050	Credit restraint continues.	Senegal
7	Current-account surplus estimated at $4 billion in 1979.	Oct.	+ 14%	Sept.	+ 10%	7.00%	1.2250	Credit remains readily available.	South Africa
4	Current-account deficit remains above $500 million.	Mar.	+ 27%	Sept.	+ 22%	—	2.01	Foreign-exchange controls eased significantly.	Sudan
1	Oil revenues rising sharply.	Sept.	+ 10%	Sept.	+ 11%	5.75%	2.63	Euroloans of $42.5 million obtained for phosphate and oil.	Tunisia
0	Oil contracts with several countries call for average price of $30/barrel.	Sept.	+ 10%	May	+ 30%	9.00%	n.a.	Money supply declined during first half 1979.	Iran
0	LPG prices raised 6% in December, fourth consecutive monthly increase.	June	+ 4%	Sept.	+ 54%‡	—	3.69	Proposal to denominate contracts in dollars, vs. KDs.	Kuwait
0	Agreements with foreign firms pending to refine and market oil in the West.	Sept.	+ 2%	July	+ 40%‡	—	.3000	Bank credit to private sector expanding steadily.	Saudi Arabia
0	January Abu Dhabi oil prices up 28% from October.	n.a.	n.a.	Sept.	+ 23%‡	—	.2700	UAE Supreme Council approves bill to create central bank.	United Arab Emirates

‡Private sector only

World Interest Rates

market rates of January 16, 1980; bond yields as of January 11, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.50	9.50	6.00	15.00 penalty rate 18.00	9.50	2.00	6.25
Day-to-Day Money	13.50 Jan. 17	15.00	23.50	12.50	12.125	8.60	16.00	11.25	0.875	8.6875
Treasury Bills 91-day, Middle Rates	11.80	13.50	15.625	14.40 120-day	n. a.	n. a.	14.412 74-day	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	12.00 finance paper	13.95 finance paper 15% tax w/h	14.81	10.40 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	12.90	13.90 15% tax w/h	16.25	12.50 Certified	not traded	8.40	n. a.	no market	3.25 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.35	11.87	13.82	10.51 20% tax w/h	11.78	8.20	13.94	9.34	4.29	8.09
Industrial Bonds prime, long-term, new and old issues, average yield	11.85 Aa Industrials	12.17	14.91	12.35 20% tax w/h	12.93	8.07	14.19	10.31	5.35	6.94
Bank Short-Term Rate to Best Borrowers (prime rate)	15.25	15.00	18.00	15.25	13.10	9.75	20.00	15.50	4.50	6.50
Bank Time Deposits 3-month	13.125 Cert. of Dep.	13.85 Cert. of Dep.	16.75	14.45	12.50	8.65	10.75	12.00 large deposits	5.3125 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.125	no market	17.00	no market	13.00	8.25	no market	11.125	5.1875	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8576	2.2730	.035642	.2461	.5775	.001239	.5230	.6260	.004188
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.37 *P*	2.45 *D*	.10 *D*	.80 *P*	5.75 *P*	9.00 *D*	2.75 *P*	8.75 *P*	6.10 *P*

Eurodollar Deposits
(London, interbank, bid)
January 17

7-day	13.6875
1-month	13.875
3-month	13.9375
6-month	13.875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.16
U.S.-Canada Treasury Bills	−1.45
U.S.-Canada Finance Co. Paper	−2.13
Eurodollars-U.K. Local Auth. Deposits	− .30

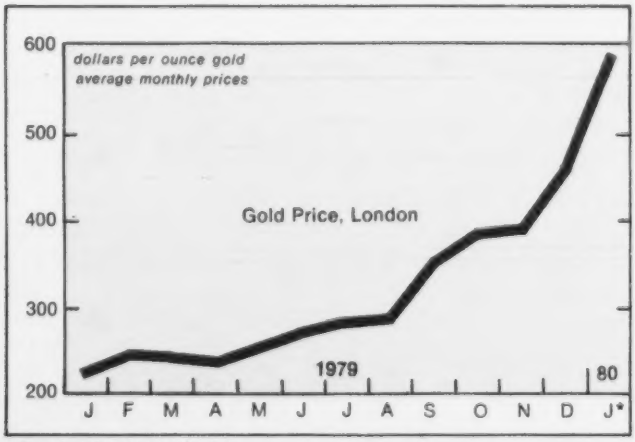
Eurbonds
(average yield on recent straight debt issues)

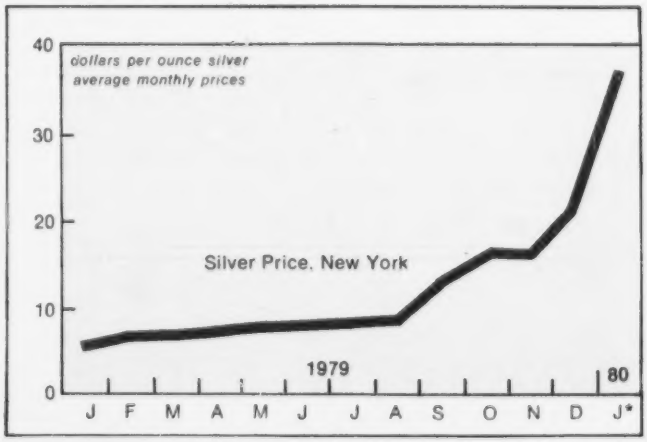
U.S. Dollar Bonds	
7 yrs. and under	11.60
Over 7 yrs.	11.70
DM Bonds	
7 yrs. and under	7.875
Over 7 yrs.	7.875

Gold Price
London afternoon fixing
760.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Gold and silver price rises accelerate





* *Based on first two weeks data*

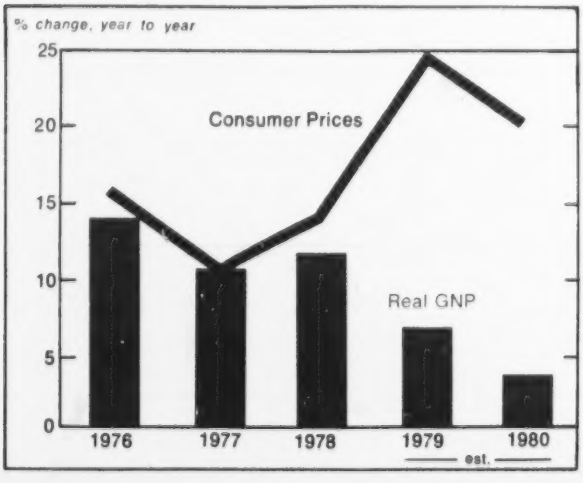
Korean Economy in Transition

The death of South Korean President Park Chung Hee last October 26 ended an 18-year regime that brought immense increases in Korea's wealth and influence in the world. Between 1976 and 1978, when already expansionary policies were intensified, real GNP soared 39.4%—an average of 11.7% per year—while exports rose 254%, from $5 billion in 1975 to $12.7 billion in 1978.

Over the course of this three-year period, however, the economy began showing signs of structural distortion and strain. The economic overheating prompted the Park Government to introduce an ambitious economic stabilization program in late 1978, although in the months prior to Park's death some elements of the austerity program were slackened in response to political pressure. Still, the interim Government of Choi Kyu Hah has promised continuity in the stabilization effort. The devaluation of January 12, together with other measures taken concurrently, demonstrate that the transition in political power has not precluded decisive economic policy action.

Economic policy under Park

During the 1976-78 period of especially rapid growth, a cornerstone of the expansion was a huge government-sponsored program of investment in heavy industry, featuring expansion of steel, petrochemical, and machinery capacity. The rationale was that Korea could not depend indefinitely on labor-intensive light industry as living standards and wage costs rose. However, at the same time the heavy-industry program was proceeding, output in all the older export industries was being pressed to a maximum, supported by government policies of easy credit. As a result, unemployment nearly disappeared and shortages of skilled labor emerged, which began to hinder the performance of several key industries.



Money supply and wage rates soared, and the inflation rate accelerated to over 14% in 1978, despite a broad range of price controls. The current account, which shifted from a deficit of $313 million in 1976 to a surplus of $12 million in 1977, posted a deficit of over $1 billion in 1978.

The emerging strains led the Park Government, following the election of December 1978, to pursue a policy of stabilization. Investment programs were either cut back or deferred, especially steel expansion plans. The economic growth target was lowered to the 8%-9% range, and credit restraints were introduced to support a target of 25% for money supply growth in 1979—although government-controlled interest rates were not permitted to increase. The government budget was to be shifted into surplus, partly by limiting wage increases of government employees to 15%.

When it became apparent that the program might be too harsh—as manifested by the insolvency of a major trading firm and the threat of other bankruptcies—several aspects were modified. Credit availability was eased selectively, and a proposal to trim the subsidized rate for exports (9%, compared with a prime rate for domestic borrowers of 18.5%) was shelved. In addition, the farm support price of rice was boosted 22%, which ensured the continuation of a large extra-budgetary Grain Management Fund deficit. As a result, the money supply increase for 1979 came in at around 30%, 4-5 percentage points over target, while the government budget was just barely kept in balance. Real GNP growth in 1979 is estimated at 7.1%, and consumer prices increased by approximately 25%.

Balance of payments deterioration

South Korea registered a sharply increased balance-of-payments deficit in 1979. Preliminary figures indicate that the trade deficit reached $4.3 billion and the current-account deficit, $3.9 billion. The value of exports rose only 18.5% to $15.1 billion, falling short of the $15.5-billion target. Exports were held back by credit restraints; increasing protectionism abroad and otherwise weak foreign demand; and by a loss of price competitiveness stemming from an overvalued currency. (The exchange rate of the Korean won stood unchanged from December 1974 through 1979, despite the high double-digit inflation rates of recent years.)

On the import side, capital goods and crude oil imports rose sharply, raising total import growth to 38% in 1979, versus 37.7% in 1978. The jump in capital equipment imports was attributed to large orders placed prior to the stabilization effort. And higher oil imports were a necessary result of the emphasis on energy-intensive heavy industry development. Crude

Korean Economy in Transition *(continued from page 7)*

oil imports cost South Korea approximately $4 billion in 1979, as against $2.3 billion in 1978, and oil consumption continues to outpace the growth in GNP.

The 1980 trade deficit is expected to be even larger than that of 1979. Capital goods imports will decline, but oil imports alone will cost roughly $6 billion. Exports, on the other hand, will be hurt by recession in the key U.S. market. The 16.55% devaluation of January 12, which pared the won's value from 484 to 580 per U.S. dollar, should enhance export competitiveness for a while, but unless inflation can be curbed quickly, the advantage will be eroded.

Despite the present and continuing gap in the current account, Korean foreign-exchange reserves remain adequate, at slightly over $5 billion. Still, with annual imports approaching $20 billion, they do not provide a sufficient cushion; and since the Government is reluctant to run them down, borrowing requirements are substantial.

External-account indicators

millions of dollars

	1976	1977	1978	1979 est.	1980 est.
Trade balance	−590	−477	−1,781	−4,300	−5,500
Current-account balance	−313	12	−1,085	−3,900	−4,700
International reserves	2,961	4,307	4,920	5,500	6,200

Prior to Park's death, South Korea undertook the last of a series of major syndicated borrowings for 1979. Total borrowings last year were on the order of $5 billion. The gross borrowing requirement for 1980 —including funds to cover amortization and a slight rise in reserves—is estimated at approximately $6 billion. South Korea is almost certain to turn to the International Monetary Fund for further drawings. As of end-December, its drawings totaled only $360 million against an overall IMF drawing potential of nearly $700 million.

Although external borrowing requirements will continue heavy this year, South Korea's external debt is expected to remain of reasonable size relative to GNP and export earnings. The debt-service ratio, 10% in 1979, is not likely to exceed 11% this year. Thus, the country will probably continue to enjoy a high credit rating with foreign lenders, particularly U.S. banks, which are its chief sources of commercial credit. This, however, will depend upon whether the current interim government maintains order in the transition of political power.

The outlook through 1981

The recent devaluation is only part of a package of measures that includes budget cuts and sharp increases in interest rates. Taken together, these actions constitute a tough program designed to pull down the inflation rate to more manageable levels, almost certainly at the cost of reducing GNP growth and raising the level of unemployment. This is hardly likely to be a popular policy, and its adoption shows not only decision-making unity within the Government, but willingness to take political risks. Evidently, the events of mid-December, which resulted in the sudden replacement of a number of top military figures, did not destabilize the interim regime of President Choi; they may in fact have strengthened it.

In view of the new policies, 1980 GNP growth will almost certainly be low, probably not more than 4%. The new export goal of $17 billion is only 13% above 1979, with most of it likely to be inflationary rather than real growth. The 1980 forecasts are for a trade deficit of $5.5 billion and a current-account gap of $4.7 billion.

By 1981, several more favorable factors should be operating to bolster economic activity. The U.S. market should be recovering from recession, and the stabilization effort should have by then helped reduce the balance-of-payments deficit. In addition, the major capital investment programs of 1976-78 should all be completed and productive, and a new permanent government should be in a stronger position to take the measures necessary to facilitate a return to rapid growth.

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